

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:TL-N-1936-00
[REDACTED]

date:

to: [REDACTED], Team Coordinator, [REDACTED]

from: Associate District Counsel, [REDACTED] District, [REDACTED]

subject: [REDACTED], EIN [REDACTED] Tax Year [REDACTED]
Treatment of settlement proceeds paid by [REDACTED]

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and, if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to persons beyond those specifically indicated in this statement or to taxpayers or their representatives.

This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memo responds to your memorandum dated March 24, 2000, regarding the allocation of payments and expenses in settlement of litigation and the proper characterization of those payments for employment tax purposes.

ISSUES

1. What is the proper tax treatment for payments made to settle litigation, including payments received from insurance carriers, for a lawsuit arising from an assignment of a patentable process and termination of an employee?
2. What is the proper tax treatment for legal expenses incurred in defending and settling this litigation and to obtain insurance coverage for it?
3. Is the amount paid to settle the wrongful employment termination claim "wages" for purposes of FICA, FUTA and income tax withholding?

CONCLUSIONS

1. The portion of the settlement payment allocable to the assignment of the patentable process is a capital expense and should be added to the basis of that asset. The portion of the settlement payment allocable to the employment termination is an ordinary and necessary business expense and is deductible. Payments received from insurance carriers are subject to the same treatment - capital or ordinary - as the underlying claims.
2. Legal expenses incurred for this litigation are subject to the same tax treatment as the underlying litigation. Unless specific information is provided indicating a different allocation, legal expenses should be divided proportionately to the settlement paid for the assignment of the patentable process claim and for the wrongful employment termination claim.
3. Yes.

FACTS

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

On [REDACTED] [REDACTED] filed a lawsuit in the Superior Court for the State of [REDACTED], County of [REDACTED], against [REDACTED] and two of its officers, [REDACTED] and [REDACTED].

From [REDACTED] until [REDACTED] [REDACTED] through his own corporation, was an independent [REDACTED] for [REDACTED]. During this time, [REDACTED] developed a process later known

[REDACTED]

In [REDACTED] [REDACTED] became an employee of [REDACTED]. In [REDACTED] [REDACTED] executed an assignment to [REDACTED] of the rights to use and patent the [REDACTED]. In exchange, [REDACTED] made an oral promise to pay [REDACTED] for the assignment once the value of the invention became more ascertainable. [REDACTED] ultimately obtained [REDACTED] patents on the Process.

The [REDACTED] enabled [REDACTED] to become the [REDACTED] manufacturer of [REDACTED] [REDACTED] name. The [REDACTED]

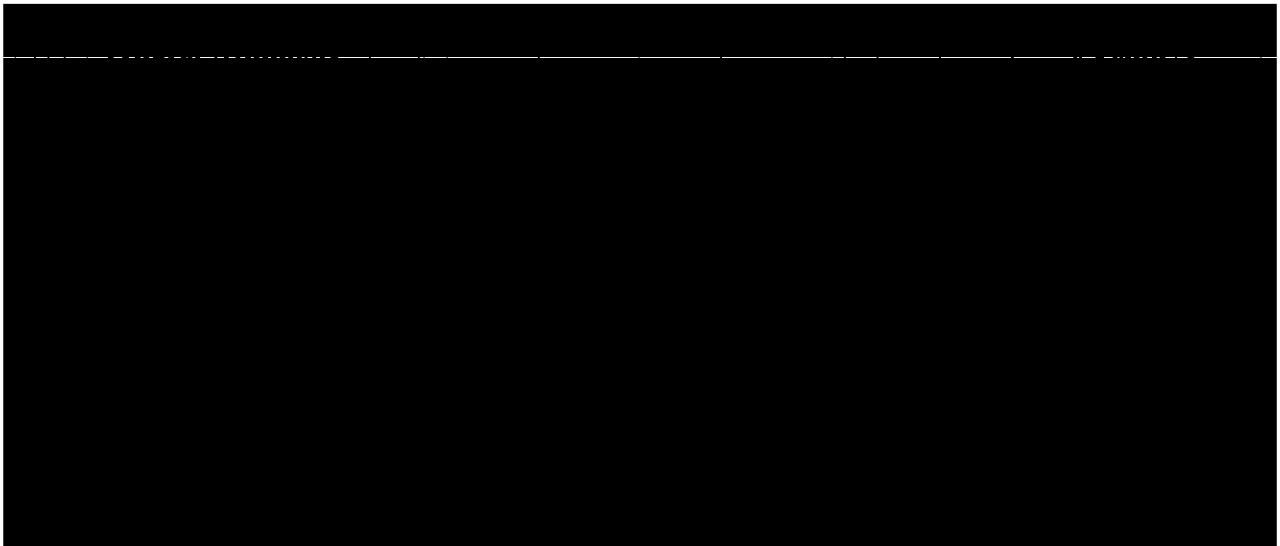
called the [REDACTED] " [REDACTED] " From [REDACTED] to the present, [REDACTED] used the [REDACTED] in the manufacture of its [REDACTED] [REDACTED] comprised a [REDACTED] of [REDACTED] s sales from [REDACTED] through [REDACTED]

In [REDACTED] [REDACTED] terminated [REDACTED] s employment after lengthy negotiations concerning a new employment contract and consideration owed [REDACTED] for the assignment of the [REDACTED]. [REDACTED] had never been paid for the assignment. At the time he left [REDACTED] s employment, [REDACTED] was paid a base salary of \$ [REDACTED] per year plus discretionary and nondiscretionary bonus compensation. He was also receiving various benefits such as health and life insurance. With his termination he lost numerous unvested options to purchase [REDACTED] stock.¹

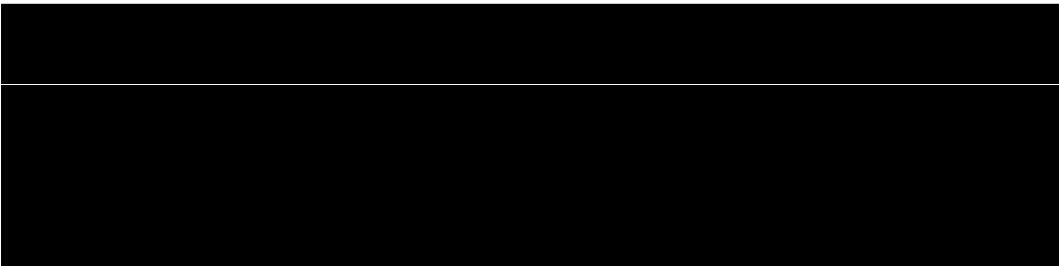
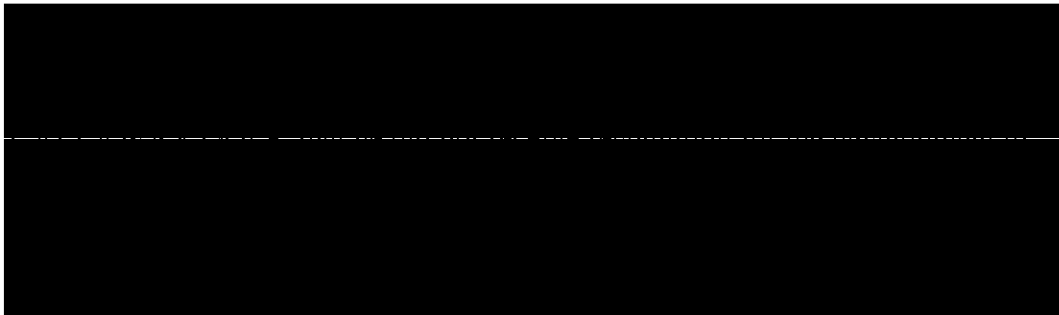
[REDACTED] s lawsuit arises from two main claims - misappropriation of his [REDACTED] [REDACTED] and wrongful termination of his employment. The specific allegations and requests for relief, as stated in [REDACTED] s Amended Complaint, are described below.

Cause of Action	Prayer
[REDACTED]	

¹ It is not clear from [REDACTED] s complaint or the settlement agreement the number of shares available pursuant to the unvested stock options. The complaint places the number at [REDACTED]. The settlement agreement does not state a number but says "[REDACTED] [REDACTED]" and "[REDACTED] [REDACTED]"



The settlement agreement states the following:



In settlement of this matter, [REDACTED] paid [REDACTED] \$ [REDACTED]² The parties also entered into a [REDACTED]-year employment contract for [REDACTED] to serve as the [REDACTED] Pursuant to this contract, [REDACTED]'s salary is \$ [REDACTED] per year plus health

² The settlement agreement states that [REDACTED] will pay this amount on behalf of itself and the officers named in the complaint, [REDACTED] and [REDACTED].

insurance, pension plan and other employee benefits. It also provides for [REDACTED] to receive options to purchase [REDACTED] shares of common stock at the current market price ([REDACTED] vesting in [REDACTED], [REDACTED] in [REDACTED] and [REDACTED] in [REDACTED]). In return [REDACTED] agreed to provide [REDACTED] with his "[REDACTED]" The agreement also contains a clause (paragraph [REDACTED]) which states:

[REDACTED]

[REDACTED] issued a Form 1099 to [REDACTED] for the \$ [REDACTED] settlement amount. It appears that there was no withholding by [REDACTED] on this amount.³ [REDACTED] deducted the full amount on its [REDACTED] Federal Income Tax Return. In your memo dated [REDACTED] you propose a division of the settlement proceeds as follows:

Assignment of the [REDACTED]	\$ [REDACTED]
Wrongful Employment Termination	
Lost Salary	\$ [REDACTED]
Lost Stock Options	\$ [REDACTED]
Total	\$ [REDACTED]

The lost salary is calculated by multiplying [REDACTED]'s salary at the time he was terminated by the months of lost salary ($\$ [REDACTED] \times [REDACTED] = \$ [REDACTED]$). The value of the lost stock options is calculated by taking the number of lost options multiplied by the NYSE market price at the time the lawsuit was filed less the number of lost options multiplied by the average exercise price of the lost options ($([REDACTED] \times \$ [REDACTED]) - ([REDACTED] \times \$ [REDACTED]) = \$ [REDACTED]$). In support of the allocation to the [REDACTED], you mention that in [REDACTED] [REDACTED] offered to accept \$ [REDACTED] for the assignment plus a \$ [REDACTED] royalty per [REDACTED] on all subsequent sales.

[REDACTED] incurred various legal expenses in its defense and settlement of the [REDACTED]

³ The settlement agreement states that: "[REDACTED]"

[REDACTED]

litigation. Although the total amount of these expenses is not known at this time, [REDACTED] deducted \$ [REDACTED] in [REDACTED] for legal fees related to the [REDACTED] litigation.

After [REDACTED] commenced his litigation against [REDACTED] [REDACTED] tendered the claim to its insurers. Certain insurers denied coverage. [REDACTED] initiated litigation in [REDACTED] against those carriers who denied coverage, for the costs associated with the [REDACTED] litigation and its settlement. During [REDACTED], an insurance agent and one of the insurers settled with [REDACTED]. The litigation against the remaining insurers was unsuccessful as of [REDACTED]. At that time, [REDACTED] appealed an adverse ruling from the [REDACTED] Superior Court.

DISCUSSION

1. *[REDACTED]'s Payment in Settlement of the Assignment Claim Is to Be Capitalized; its Payment in Settlement of the Employment Termination Claim Is Deductible.*

The test to determine the proper tax treatment of settlement payments is the "origin of the claim" test. United States v. Gilmore, 372 U.S. 39, 49 (1963). Woodward v. Commissioner, 397 U.S. 572, 577-78 (1970), United States v. Hilton Hotels Corp., 397 U.S. 580, 583 (1970). The origin and character of the claim with respect to which an expense is incurred, rather than its potential consequences upon the fortunes of the taxpayer, determine the proper tax treatment. Gilmore, 372 U.S. at 49. The issues involved, the purpose for which the amount was expended, the background of the litigation, and all the facts pertaining to the controversy are to be considered in determining the origin of the claim. Boagni v. Commissioner, 59 T.C. 708, 713 (1973) *acq.*, 1973-2 C.B. 1⁴; Harold Levinson Associates, Inc. v. Commissioner, T.C. Memo. 1997-536.

The origin of the claim test is also applied to distinguish between deductible business expenditures and capital expenditures. Anchor Coupling Company v. United States, 427 F.2d 429, 433 (7th Cir. 1970). In such situations, settlement proceeds are allocated among the claims. Burch v. United States, 698 F.2d 575, 579 (2nd Cir. 1983). The complaint is a useful tool for determining the proper allocation of proceeds among the claims asserted. Rev. Rul. 85-98, 1985-2 C.B. 51. Reasonable estimations using best judgment and based on the available evidence are sufficient to determine the proper amount to allocate to each claim. See e.g. Burch, 698 F.2d at 579-80; Spangler, T.C. Memo 1961-341, *aff'd* 323 F.2d 913 (9th Cir. 1963); Blackburn v. Commissioner, T.C. Memo. 1973-254.

[REDACTED]'s case against [REDACTED] arose from two main controversies, [REDACTED]

⁴ The Ninth Circuit, however, criticized Boagni's statement of the origin test in Keller Street Development Co. et al v. Commissioner, 688 F.2d 675, 680 (9th Cir. 1982). Keller clarifies that the underlying litigation, and not the tax action, is the activity to be examined. *Id.* at 680-81. Also, usage of the terms "objectives" and "purposes" in Boagni should not be confused with the "primary purpose" test because the Supreme Court rejected the primary purpose test in United States v. Gilmore, 372 U.S. 39 (1963). *Id.* at 680.

during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary. Indopco, 503 U.S. at 85. A deduction is not allowed for capital expenditures. I.R.C. § 263(a)(1).

A settlement payment is necessary where (1) the taxpayer was not entirely confident the lawsuit would fail, (2) the payment was made for the purpose of avoiding the damages or liability that might have resulted from the lawsuit and (3) the decision to settle the suit was reasonable under the circumstances. Old Town Corp. v. Commissioner, 37 T.C. 845, 858-59 (1962), acq., 1962-2 C.B. 5. Here, [REDACTED] was an adverse party to [REDACTED]. In such a situation a taxpayer's judgment in the necessity of incurring litigation expenses is typically respected. Id. at 857. This is because it is believed that a taxpayer when dealing with an adverse party, will not incur such expenses unless they are actually required. Id.

Amounts paid in settlement of the litigation are considered ordinary if the acts giving rise to the litigation were performed in the ordinary conduct of the taxpayer's business. Welch v. Helvering, 290 U.S. 111, 114 (1933); Anchor Coupling, 427 F.2d at 432. The employment of [REDACTED] by [REDACTED] is ordinary conduct in [REDACTED]'s business.

Because the payment in settlement of [REDACTED]'s wrongful employment termination claim is an ordinary and necessary business expense, it is deductible by [REDACTED].

(c) *Allocation of Settlement Proceeds Between [REDACTED]'s Two Claims Should be Reasonable in light of the Available Information.*

You allocated the Settlement Proceeds to the [REDACTED] claim and the wrongful employment termination claim as follows:

[REDACTED]	\$ [REDACTED]
Wrongful Employment Termination	\$ [REDACTED]

To determine how to allocate portions of a settlement agreement for tax purposes, courts look to the best objective evidence available under the facts and circumstances of the case. San Francisco Baseball Associates L.P. v United States, 88 F.Supp. 2d 1087, *17 (N.D. Cal. 2000); Burch, 698 F.2d at 579-80.

Your suggested allocation to the wrongful employment termination claim is comprised of lost wages (\$ [REDACTED] x [REDACTED] months) and lost stock options ([REDACTED] at \$ [REDACTED]). You allocated the remainder of the \$ [REDACTED] to the [REDACTED]. You treated the employment contract and compensation for future work as a separate matter.

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(7)a

[REDACTED]

The employment contract portion of the settlement provides that [REDACTED] receive a salary of \$ [REDACTED] per year for [REDACTED] years, full employee benefits and [REDACTED] stock options, all to be vested on or before the end of the [REDACTED] years. It requires [REDACTED] assign to [REDACTED] "[REDACTED]" created during the duration of the contract. It also contains a clause which states:

[REDACTED]

, (b)(7)a

[REDACTED]

⁶ (b)(7)a

[REDACTED]

[REDACTED] See e.g., Burch, 698 F.2d 575 (dispute over ownership of assets and over income from managing the same assets treated as two types of expenditures)

- (d) *Insurance Proceeds, Unless Paid for a Specific Purpose, Should Be Taken into Income or Used to Reduce Basis Proportionately to the Allocation of the [REDACTED] Litigation.*

[REDACTED] obtained coverage from certain of its insurance carriers for the costs incurred in the dispute with [REDACTED]. The amount received should either be included in income or subtracted from [REDACTED]'s basis (assuming the earlier payment by [REDACTED] was added to basis) in the [REDACTED] depending upon whether the settlement proceeds were to compensate [REDACTED] for the Process claim or the wrongful employment termination claim. (b)(5)(AC), (b)(5)(AC), (b)(7)a

2. *Legal Costs Incurred in the Settlement of Litigation Are Accorded the Same Tax Treatment as the Underlying Claims with Which They Are Associated.*

Tax treatment of settlement costs depends upon the tax treatment of the settlement itself. Spangler, 323 F.2d at 918. Expenses incurred to defend or perfect ownership in a capital asset are capital expenditures and are not deductible. Id. at 919. Similarly, expenses incurred in arriving at a fair price for capital asset are not deductible. Baier, 533 F.2d at 120.

Here, [REDACTED]'s settlement is partly for the assignment of the [REDACTED] - a capital expense, and partly for [REDACTED]'s wrongful termination - an ordinary and necessary business expense. To the extent that the costs of litigation were for the [REDACTED], they should be added to [REDACTED]'s basis in the Process. (b)(7)a

[REDACTED]. See Spangler, T.C. Memo. 1961-341, aff'd, 323 F.2d 913 (9th Cir. 1963).

(b)(7)a

3. *To the Extent the Settlement Was for Wages, it is Subject to FICA, FUTA and Income Tax Withholding.*

All remuneration for employment, unless specifically excepted by statute, constitutes wages. I.R.C. §§ 3121(a) (FICA), 3306(b) (FUTA) and 3401(a) (withholding from wages). Generally, a payment made by an employer to an employee or former employee, in consideration of the termination of employment, is wages for purposes of FICA, FUTA and income tax withholding. Treas. Reg. §§ 31.3121(a)-1(i), 31.3306(b)-1(i) and 31.3401(a)-1(a)(5); Social Security Board v. Nierotko, 327 U.S. 358, 364-65 (1946) (FICA); San Francisco Baseball Assoc., 88 F.Supp. 2d at *10 (FICA, FUTA); Rev. Rul. 72-572, 1972-2 C.B. 535 (FICA, FUTA, wage withholding). The employee need not have actually worked during the time period in question so

long as an employer-employee relationship existed and the payments reflect compensation. - -
Nierotko, 327 U.S. at 365. Even future wages that would otherwise have been paid are included.
Gerbec v. United States, 164 F.3d 1015, 1026 (6th Cir. 1999).

To the extent the settlement paid to [REDACTED] was for the employment termination claim, it is wages and is subject to FICA, FUTA and income tax withholding.

If you have any questions, please contact [REDACTED] at [REDACTED].

[REDACTED]
Associate District Counsel

By:

[REDACTED]
Attorney